No. 11,168

# United States Circuit Court of Appeals

## For the Ninth Circuit

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PARROTT & COMPANY, a corporation, *Appellant*

vs.

UNITED STATES OF AMERICA, *Appellee*

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Upon Appeal from the District Court of the United States for the Northern District of California, Southern Division, before Judges Denman, Healy and Bone.

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## Appellant's Supplemental Brief

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MISCELLANEOUS

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## Appellant's Supplemental Brief

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By permission of the court, this supplemental brief is filed, its purpose being to cite authorities and regulations which are not covered by appellant's opening brief; also, to refer to contentions made by counsel during argument. The numerical citations below, such as 190.157, refer to the 1940 Supplement of the Code of Federal Regulations, title 26.

## I) RECTIFICATION TAX

Rectifiers pay an occupational tax (190.157) and can only use liquors that have been previously tax-paid (190.202). While still in bond, i.e., before being tax-paid, "distilled spirits of the same kind, differing only in proof, . . . may be mingled together" (188.45). Also, while in a rectifying plant, necessarily after payment of the distilled spirits tax, homogenous spirits may be mixed or mingled without incurring the rectification tax (190.351). Therefore, if the rum described in formula 10 (R 6) had been produced in the United States it would not have been "rectified." See also *US v. Thirty-two Barrels,* 5 F 188, stating (190):

> A rectifier is one who changes liquors by adding to them or compounding them or rectifying them; and yet the courts have held, under the statute defining what a rectifier is, that the mere addition of water to his spirits would not make him a rectifier, or the mixing of certain spirits of the same character, if they were under a certain age, would not be rectification.

A complete statement as to the scope of the rectification statute is found in a ruling by the Commissioner of Internal Revenue, dated Sept. 16, 1869, shortly after the initial enactment of this statute in 1868. It is published in 10 Int. Rev. Record 120, and appears in the appendix hereto.

## II) DISTILLED SPIRITS TAX

a) *Insular possessions:* Taxation of spirits from an insular possession was first the subject of legislation in

the Foraker Act of April 2, 1900, relating to Puerto Rico and specifying (as does 26 USC 3350 relied upon by the appellee here) that upon arrival in the United States products of Puerto Rico should pay a tax:

> equal to the internal-revenue tax imposed in the United States upon the like articles of domestic manufacture.

At the same time, the statute RS 3251, contained the prototype of section 2800 (a) (1), which, as amended, levied an internal-revenue tax on distilled spirits of $1.10 per proof gallon *or wine gallon when below proof.*

The Commissioner of Internal Revenue in Treasury Decision 404 of August 15, 1901 considered the application of the relevant statutes taxing domestic distilled spirits and of the Foraker Act with regard to Puerto Rican bay rum and held:

> . . . bay rum, *if produced in this country,* either by original distillation or by compounding with non-tax paid spirits, would be subject to tax, *and according to the quantity of spirits contained* therein; and it seems equally clear that this tax would, under the provisions of section 3 (Foraker Act) attach to like spirits of Puerto Rican manufacture coming into the United States.

The Supreme Court passed upon the subject in *Jordan v. Roche,* 228 US 436, when it held that the Foraker Act required taxation of Puerto Rican bay rum upon arrival in the United States as "distilled spirits" because the distilled spirits tax was levied upon articles (p 445):

> * * * according to their alcoholic content under the generic name of distilled spirits.

Also, the court held that an act of February 4, 1909, specifically levying a tax upon Puerto Rican bay rum at $1.10 per proof gallon was (p 445):

> a more explicit expression of the purpose of the prior law made necessary by judicial construction of that law.

In *Borun v. US*, 61 Ct. Cl. 425, *Jordan v. Roche, supra*, was reviewed, the court stating that it was there held that:

> the purpose of the Foraker Act of April 12, 1900, 31 Stat. 77, was to subject Puerto Rican articles to the internal-revenue laws of the United States *and that under these laws articles are taxed* not by their commercial names or uses but *according to their alcohol content* under the generic name of "distilled spirits" . . .

Current statutes relating to the products of Puerto Rico, the Philippine Islands and the Virgin Islands are found in 26 USC, sections 2800 (a) (4), 3340 and 3350. These statutes have been construed by the Treasury as requiring taxation upon the alcoholic content of liquors. See 26 Code Fed. Reg., 1941 Supp., sections 180.60, 180.46 and 180.94, stating that such articles are:

> subject to a tax *equal to* the internal revenue tax imposed *upon the production* in the United States of like liquors.

Also, articles other than liquors which contain distilled spirits (180.2) are subject, under sections 180.60, 180.46 and 180.94, to:

> *tax upon the liquors contained therein* at the rates imposed in the United States *on like liquors* of domestic production.

b) *Taxation of like domestic articles:* The Revenue Act of 1918, 26 USC 3350, states that Virgin Islands products upon coming into the United States shall pay:

> a tax equal to the internal revenue tax imposed in the United States upon like articles of domestic manufacture.

Here, in assessing the rectification tax, appellee obviously determined that this rum was a "like article" to domestic rum produced in the same manner as the Virgin Islands rum was produced. In other words, appellee looked to the method of production in order to determine whether the rum had been rectified. Therefore the method of production should likewise be followed in determining the amount of the distilled spirits tax.

The alleged facts in their simplest form are that this rum (R 4):

> * * * had been first distilled at over 100 proof and later by the addition of water was reduced to less than 100 proof.

For the purpose of demonstrating appellant's contention, reference is made to the further fact that the rum produced by formulas 3 and 5 (which are not set forth in the complaint) was of 90 proof upon arrival in the United States or upon withdrawal from customs warehouse (see scheduled data, R 16-8, column 5, and explanation of this schedule, R 15). Therefore the taxable status of the rum identified as having been produced under formulas 3 and 5 is to be determined by reference to domestic rum which likewise was "first distilled at over 100 proof and later by the addition of water was reduced to less than 100 proof," namely to 90 proof.

That the tax on such rum made in the United States would be on the proof and not the wine gallon basis is readily and conclusively demonstrated by reference to the following sections appearing in 26 CFR, 1940 Supplement:

The distilled spirits tax would have attached as soon as the rum of over 100 proof came into existence (183.257) and the distiller would have been liable for its payment (183.259).

At this point the distiller had two choices; namely, to withdraw from warehouse with tax payment upon the proof gallon basis, or to reduce the rum to not less than 90 proof by the addition of distilled water. See section 186.135, reading as follows:

> 186.135 Reduction in proof on warehouse premises. Distilled spirits contained in distillers' original packages may be reduced in strength to a proof of not less than 90 degrees *after having been gauged for withdrawal from the internal revenue bonded warehouse,* and after having been removed from the warehouse but before removal from the premises, or after they have been removed from the premises tax-paid and are still in the possession of the proprietor at his free warehouse.

As is shown by this regulation, the addition of water would have occurred *after* the rum had "been gauged for withdrawal from bonded warehouse," in other words, after the taxable quantity had been ascertained.

Thus, by a reference only to rums of formulas 3 and 5, which are 90 proof, and to the regulations cited above, it is demonstrated that the tax "equal to the internal revenue tax imposed in the United States upon *like* articles

of domestic manufacture" (26 USC 3350) is a tax levied upon the proof gallon and not the wine gallon.

The schedule attached to the complaint (R 16-8) does not set forth any amounts due appellant with regard to this proof v. wine gallon issue as to the rum covered by warehouse entries 359 and 546, and produced under formulas 5, 10, 11 and 12. This is because the Commissioner of Internal Revenue refunded the amount thus due appellant upon the filing of claims after tax on the wine gallon basis had been paid to the collector. Therefore, appellant's cause of action extends only to the rum covered by warehouse entries 964, 4623, 4790 and 5748, and produced by formulas 2, 3, 4, 5, 6 and 7 (R 16-8).

As is shown above, the rum covered by formulas 3 and 5 was of 90 proof and for reasons stated was taxable upon the proof gallon basis. Therefore the only additional rum involved in this point is that covered by formulas 2, 4, 6 and 7, which, as alleged in paragraph II (R 4), was likewise:

> first distilled at over 100 proof and later by the addition of water was reduced to less than 100 proof.

Such rum when produced in the United States at over 100 proof could have been tax-paid upon that basis or, alternatively, as described above, could have been reduced in proof but not to less than 90 *while in bond* with tax payment upon the proof gallon basis. Therefore any reduction below 90 (i.e. to 86) would necessarily have been carried on in a rectifying plant under authority of 190.346, but without incurring the rectification tax (190.353). See also *US v. Thirty-two barrels, supra,* holding that addition of water does not result in rectifying-tax liability.

Further, as the distilled spirits tax must be paid *upon withdrawal* from bonded warehouse (26 USC 2800 (a) (1), and as only tax-paid spirits can be received in a rectifying plant (190.168), it follows that the reduction to 86 proof would have taken place *after* withdrawal from warehouse. Consequently, appellant's allegations also stated a cause of action with respect to the remaining rum covered by formulas 2, 4, 6 and 7.

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## III) COMMENTS UPON APPELLEE'S BRIEF

At page 8 appellee states that the purpose of enactment of section 3350 (a) was to provide for payment of taxes on articles brought into the United States from the Virgin Islands:

> in a sum equal to the taxes on like articles manufactured in the United States.

This is also appellant's contention, but the collector did not so assess, for he not only exacted a rectifying tax equal to that collected in the United States, but also collected a larger sum than would have been assessed had the rum been produced in the United States under like circumstances. To illustrate: The tax in the case of the 86 proof rum covered by formula 7 (warehouse entry 4790) was 30 cents per proof gallon plus $3 per wine gallon, with the following comparative results:

| Assessed tax on each 4 quarts Virgin Island rum | | Tax in the United States on 4 quarts of rectified rum | |
|---|---|---|---|
| Rectification—30¢ x .86 of 1 gallon | $ .258 | Rectification—30¢ x .86 of 1 gallon | $ .258 |
| Distilled spirits—$3 x 1 gallon | 3.00 | Distilled spirits—$3 x .86 of 1 gallon | 2.580 |
| Total | $3.258 | Total | $2.838 |

On page 20 appellee argues that the tax should be determined with regard to the condition of the Virgin Islands rum at the time it was:

> withdrawn from the customs bonded warehouse; that is, as to the kinds of spirits, *the proof of the spirits* and the rates of tax. At the time of withdrawal from the customs bonded warehouse the spirits were 86 proof, and therefore taxable on the wine gallons.

This argument does not accord with the statute (26 USC 3350) which requires equality with the amount of tax assessed on like domestic articles. Also, it does not accord with the present regulations, which authorize taxation according to method of production in the Virgin Islands. Further, a patent weakness of the contention is demonstrated by reference to the fact that Virgin Islands merchandise, including rum, is frequently tax-paid immediately upon arrival in the United States *and without being placed in customs bonded warehouse.* Therefore, adoption of such a rule could lead only to confusion.

Appellee's counsel also cited 26 CFR, 1940 Supp., sec. 186.155 (R 22), as showing that if underproof spirits are withdrawn from bond the tax is levied upon the wine-gallon basis, but he does not point out that there is an exception to this rule; namely, if a distiller chooses to reduce overproof spirits to as low as 90 proof prior to withdrawal from bonded warehouse, he may do so and still pay tax upon the proof-gallon rather than the wine-gallon basis. See sec. 186.135 supra, permitting reduction in proof to not less than 90 prior to tax payment *but after being gauged for withdrawal from bonded warehouse.*

The regulation cited by appellee (186.115) merely deals with gauging, and as shown by its own terms, *is directed toward cases where a loss of proof occurs in bonded warehouse.* Distillers frequently reduce whisky and other spirits to exactly 100 proof under authority of section 186.135 for the purpose of withdrawal and sale at that proof. However, if the spirits remain in warehouse for more than 30 days after gauging they must be regauged (186.68). Consequently, if during this time a reduction in proof takes place by evaporation of alcohol, the regulation cited by appellee (186.115) becomes operative.

Appellant's contention here can be further demonstrated by reference to ordinary business practice. Inasmuch as distillers and other persons are permitted by regulations cited above to manipulate distilled spirits in such a manner as to entitle them to taxation upon the proof-gallon basis, it seems ridiculous to assume that any such person would produce spirits at overproof and then reduce those spirits to 90 proof *prior* to ascertainment of the amount of tax, when such a reduction can be accomplished after tax ascertainment by addition of water and without incurring further tax liability. In other words, no prudent person would pay the distilled spirits tax (now $9 per gallon) on *water.* In this connection attention is called to section 1963 (4), Cal. Code of Civil Procedure, stating that it is presumed "That a person takes ordinary care of his own concerns" although the presumption may be controverted by evidence.

On pages 21-2 appellee cites several decisions holding non-compliance with mandatory regulations to be a bar to relief. Those cases are based upon the principle that when Congress provides that specific rights may be ob-

tained under regulations to be prescribed, compliance with those regulations is a condition precedent to obtaining of the right. The rule, however, is different as to regulations issued under general rather than specific authority. Then, regardless of what their effect may be when a taxpayer is dealing with administrative officers, a litigant can obtain rights granted by statute upon establishing in court that his case comes within the terms of the statute, even though he has not complied with administrative regulations. See *US v. Post Fish Co.,* 5 Ct. Cust. Appls. 130, 134; also *US v. Morris & American Express Co.,* 3 Ct. Cust. Appls. 146, stating (148):

> Where regulations are promulgated by the Secretary of the Treasury under the *general power* granted by the provisions of section 251 of the Revised Statutes to make general rules and regulations for the collection of the revenues, such are deemed and held regulative or administrative merely and not conditions precedent to the right of exemption from duty.

In the present case, the Virgin Islands statute, 26 USC 3350, contains no provision for its administration by regulation. Therefore the instant regulations (180.98, 180.99 and 181.134) were made under general authority. Consequently, compliance is not a condition precedent to recovery in court.

Further, most of the rum involved herein arrived in the United States and was tax-paid prior to issuance of the regulations on June 16, 1941. Therefore, as to that rum appellee is in effect asserting that the Secretary of the Treasury can deprive a taxpayer of a right granted by statute by failing to prescribe regulations for the statute's administration. As to this, *Hannibal Railroad*

*Company v. Smith,* 9 Wall 95, is pertinent, for it was therein held that failure of the Secretary of the Interior to furnish certain plats of land as required by a statute granting this land could not defeat the grantee's rights to the land.

Also, it is well established that administrative officials cannot alter, amend, or extend a statute. See *Williamson v. US,* 207 US 425, *Re Nellea,* 5 F 2d 687, *Riverdale v. Commission,* 48 F 2d 711, and *Helvering v. Powers,* 293 US 214.

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## CONCLUSION

It is respectfully submitted that the judgment appealed from should be reversed.

San Francisco, June 3, 1946.

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**(APPENDIX FOLLOWS)**

## Appendix

TREASURY DEPARTMENT. Office of Internal Revenue. Hon. Columbus Delano, Commissioner
(Official)

### Liabilities of Persons who Mix Spirits or Liquors of Different Strengths or Different Kinds

Office of Internal Revenue
Washington, Sept. 16, 1869

Sir: Your letter of the 1st instant has been received.

You ask if, when whiskey of different strengths is mixed, and the strength made uniform, such process is considered in the eye of the law as rectification; also, if reduction of liquors by water is looked upon as rectification.

In reply I will call your attention to the provisions of the 1st section of the act of April 10, 1869, defining rectification, and especially the clause in regard to compounding liquors for sale.

To mix distilled spirits, wines or other liquors with any material, does constitute rectification, *if by such mixing a spurious, imitation, or compound liquor is manufactured. To mix any material with distilled spirits, wine or other liquor, which does not result in producing either a spurious, imitation, or compound liquor, is not rectification.* As, for instance, though pure water is a material different from spirits, yet the addition thereof to spirits is held not to constitute rectification, as it does not result in the pro-

duction either of a spurious, imitation or compound liquor, but leaves the particular spirits, the same in kind only lower in proof.

To determine whether the mixing is rectification or not under this clause of the statute, you must, therefore, look to the result, and see whether either of the three kinds of liquors named, is manufactured by the mixing. A spurious liquor is an imitation of, and held out to be genuine. An imitation liquor is one that is in imitation of the genuine, and held out as such imitation. *A compound liquor is any liquor composed of two or more kinds of spirits mixed with any material which changes the original character of either so as to produce a different kind as known to the trade.*

It follows, therefore, that the mixing of liquors identical in kind as known to the trade, does not constitute rectification; but dealers mixing spirits, wines, or other liquors of the same kind, in making change of package, must do so in such a way as to enable them to comply with section 47, of the act of July 20, 1868. As all changes of packages made on premises of a dealer are presumed to be made for the purpose of sale, the requirements of said section apply to all such changes. Therefore a dealer must not mix spirits of different kinds, as that would be rectification; nor of the same kind from different distillers or distilleries, or rectifiers, as by so doing he places it beyond his power to mark and brand the new packages as required by said section 47, and Series 5, No. 7, Supplement No. 1 (10 Record, 82).

What is said above concerning the mixing of distilled spirits, wines, or other liquors, or of any material with such spirits, wines, or other liquors, is applicable only to

that part of section 1 of the act of April 10, 1869, concerning the compounding of liquors for sale. A party may become a rectifier under the previous clause of said section, by any manipulation of spirits, which results in rectifying, purifying, or refining the same by any process, other than by original and continuous distillation from mash, wort, or wash, through continuous closed vessels and pipes until the manufacture thereof is complete. For instance, a party may mix a material with spirits, wine, or other liquor, which will not produce either a spurious, imitation, or compound liquor, but such mixing is nevertheless rectification, if it results in either purifying, or refining the spirits, wine, or other liquors thus mixed.

C. Delano, Commissioner

R. M. Smith, Esq.,
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